DOCKET FILE COPY ORIGINAL

RECEIVED

APR 1 1 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
TELEPHONE COMPANY-	)	
CABLE TELEVISION	)	CC Docket No. 87-266
Cross-Ownership Rules	)	
Sections 63.54-63.58	)	
	)	
and	)	
	)	
Amendments of Parts 32, 36,	)	
61, 64, and 69 of the	)	RM-8221
Commission's Rules to	)	
Establish and Implement	)	
Regulatory Procedures for	)	
Video Dialtone Service	)	
(Fourth Further Notice	)	
of Proposed Rulemaking)	)	

REPLY COMMENTS OF DISCOVERY COMMUNICATIONS, INC.

Judith A. McHale
Senior Vice President and General Counsel
Discovery Communications, Inc.
7700 Wisconsin Avenue
Bethesda, Maryland 20814-3522

April 11, 1995

TABLE OF CONTENTS

Page

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of TELEPHONE COMPANY- CABLE TELEVISION Cross-Ownership Rules Sections 63.54-63.58	))))))	 CC Docket No. 87-266
and	)	
Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service (Fourth Further Notice of Proposed Rulemaking)	))))))))	 RM-8221

REPLY COMMENTS OF DISCOVERY COMMUNICATIONS, INC.

Discovery Communications, Inc. ("Discovery") hereby submits reply comments in response to the Commission's *Fourth Further Notice of Proposed Rulemaking ("Further Notice")* in the above-captioned proceeding.[1] The Further Notice seeks comment on whether the FCC's video dialtone ("VDT") policies should be modified in light of court decisions striking down the ban on a local exchange carrier's ("LEC's") provision of affiliated video programming packages directly to subscribers within its telephone service area. The record to date shows that a substantial need exists to condition LEC provision

---

[1] Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, CC Docket No. 87-266 (Fourth Further Notice of Proposed Rulemaking) (rel. Jan. 10, 1995).

of video services on safeguards that assure the ability of unaffiliated programmers and packagers to obtain meaningful access to LEC facilities and to compete on a fair and equal basis.

I. INTRODUCTION AND SUMMARY: AS A VIDEO PROGRAMMER AND FUTURE PACKAGER, DISCOVERY CONTINUES TO SUPPORT THE GOALS UNDERLYING THE COMMISSION'S VDT POLICIES

Discovery approaches the issues raised in the *Further Notice* from the perspective of a video programmer and a prospective program packager. Discovery owns and operates the Discovery Channel,[2] The Learning Channel[3] and several new program services.[4]

Discovery's networks currently compete for carriage and for viewership with more than 100 available satellite-delivered services, in addition to broadcast services and locally originated cable programming. As a programmer, Discovery has an obvious interest in ensuring that competition is as robust among multichannel video programming *distributors* ("MVPDS") as among program networks. Competition in the distribution marketplace

---

[2] The Discovery Channel features nonfiction documentaries about science, nature, technology, human events, and history. The Discovery Channel now reaches about 62 million subscribers and ranks as one of the most enjoyed and appreciated non-broadcast program services in the country.

[3] The Learning Channel features educational programs on subjects such as history, science, archeology, and anthropology for viewers of all ages. It also provides six hours of commercial-free educational programming for preschoolers every weekday morning.

[4] These channels are: a channel devoted to science; a channel devoted to animals and their environment; a channel devoted to the way people live, including cooking programs, how-to shows, travel, crafts, gardening, fashion, and collectibles; and a history channel.

maximizes Discovery's opportunities to reach subscribers and to recover the full value of its programming, both from the systems carrying its networks and from advertisers.

Discovery also is developing Your Choice TV, a satellite-based interactive multi-channel video program package and delivery system offering simple use of a set-top box and a specially-designed user interface. As a potential program packager, Discovery is interested in obtaining access to nondiscriminatory video platforms open to multiple packagers.

As both a programmer and potential packager, Discovery continues to endorse the FCC goals in this proceeding of promoting the deployment of broadband infrastructure, competition, and a diversity of services in the video marketplace.[5] These reply comments provide recommendations as to how the Commission should ensure that LECs provide video program packages directly to in-region subscribers in a manner consistent with the public interest in a competitive and diverse video programming marketplace.

To the extent that the provision of video programming over telephone company facilities enhances competition among program packagers and distributors, programmers like Discovery will benefit, and so will consumers. But allowing telephone companies to use their facilities to provide video programming -- especially their own programming -- will not necessarily result in pro-competitive effects. If the telephone companies are

---

[5] *VDT Second Report and Order*, 7 FCC Rcd 5781, 5787 (1992); *see* Reply Comments of Discovery Communications, Inc., CC Docket No. 87-266 (filed Jan. 17, 1995); Comments of Discovery Communications, Inc. on NYNEX's Applications for Section 214 Video Dialtone Authority (File No. W-P-C-6982) (filed Dec. 23, 1994).

allowed to provide video programming in a manner that gives them unfair advantages over existing distributors -- that is, advantages that result from disparate regulatory requirements or from an ability to cross-subsidize their video facilities and operations with revenues from their monopoly local exchange service, rather than from superior or more efficient provision of video programming service -- then competition in the distribution marketplace may be hindered. Similarly, to the extent that program services owned by telephone companies are not subject to the same regulatory requirements and restrictions as program services owned by cable operators, competition among *programmers* might also be artificially restrained.

The opening comments indicate a wide disparity of opinion as to which provisions of the Communications Act the Commission may rely upon in order to achieve its public interest objectives when regulating LEC provision of affiliated packages of programming directly to in-region subscribers. Discovery leaves to others the briefing and resolution of that issue. Whether the Commission proceeds on a Title II, Title VI, or some hybrid path, Discovery submits these reply comments to underscore the critical need evidenced in the record for the Commission to establish core safeguards -- particularly regarding access and competitive parity.

II. LEC PROVISION OF AN AFFILIATED PROGRAMMING PACKAGE OVER ITS VIDEO PLATFORM RAISES CONCERNS OF PROGRAMMER ACCESS THAT WARRANT CAREFUL TAILORING OF POLICIES

As a programmer and potential packager, Discovery is concerned that a LEC's provision of affiliated packages of programming on its video transport facilities might limit access by unaffiliated programmers and, therefore, their ability to compete. It is essential that the Commission regulate LEC video systems in a manner that assures unaffiliated video programmers meaningful access to the LEC systems.

If the Commission continues to regulate VDT as a common carrier Title II service, such regulation mandates that programmers and packagers be provided nondiscriminatory access at just and reasonable rates. Even under Title II, however, the Commission has found that additional safeguards -- such as a prohibition of "anchor programmers" or the assignment of all analog channels to a single entity -- are necessary to give substance to the common carriage right of access.

On the other hand, while Title VI does not mandate a right of access to unaffiliated programmers comparable to that available under a common carriage regulatory framework, several of its provisions nonetheless address access issues. Specifically, Title VI limits the number of channels on which an operator may carry affiliated programming, thereby allowing room for unaffiliated program services. Title VI regulations also preclude distributors from extracting unfair terms for carriage. Provisions of Title VI, but not Title II, also require programmers to make their program services available to unaffiliated distributors.

If program services owned by telephone companies are not subject to the same restrictions as program services owned by cable operators, then they will gain an unfair marketing advantage in the programming marketplace. Similarly, if the safeguards that prevent vertically integrated cable operators from excluding or discriminating against unaffiliated program services are not applied to telephone company packagers, services owned by telephone companies will gain an anticompetitive edge over services owned by cable operators and over independent programmers.

Accordingly, Discovery joins other commenters in recommending that the FCC tailor its regulation of LEC video services to ensure access and fair competition among programmers and packagers, regardless of affiliation. Specifically, the FCC should: (1) apply program access rules to LEC-affiliated programmers; (2) adopt VDT regulations that guarantee available channel capacity; and (3) ensure fair access to the VDT platform.

A. The Record Supports Requiring LEC-Affiliated Programmers To Provide Competing Packagers Access To Their Program Services To Promote Fair Competition Among Programmers and Packagers Regardless of Affiliation

The program access rules adopted under Title VI prohibit a vertically-integrated cable operator from refusing to make its programming available to competing video services. If the Commission regulates LEC video networks and LEC-affiliated programmers under Title VI, then the program access rules would apply to them.

In the event, however, that the Commission retains its Title II regulatory approach, Discovery concurs with MPAA that rules similar to the cable program access rules should be applied to LEC-affiliated programmers.[6] Although Discovery generally opposes restrictions on a programmer's ability to enter into exclusive carriage agreements or otherwise freely exercise its intellectual property rights, fair competition among programmers on the same video platform is not possible if cable-affiliated programmers are required to provide VDT packagers with access to their program services while LEC-affiliated programmers are not. As a potential competing program packager, Discovery would not have the same right of access to include LEC-affiliated programming in its package that the LEC packager would enjoy with respect to Discovery's programming. Discovery urges the Commission to therefore adopt rules to provide competing VDT packagers a corresponding right of access to LEC-affiliated program services.

Specifically, Section 628 of the 1992 Cable Act prohibits a vertically integrated cable programmer from entering into exclusive contracts with *any* cable operator -- not

---

[6] MPAA at 5-8. A number of LECs argue that an affiliation standard no longer is necessary or, at a minimum, that the current 5 percent threshold should be relaxed. These arguments should be rejected. If the Commission regulates LECs as cable operators under Title VI, an affiliation standard will be necessary to determine when a LEC's ownership interest in a programmer causes it to become a vertically integrated cable operator. If the Commission regulates LECs under Title II, an affiliation standard is needed to determine when capacity limits or other safeguards and restrictions on LEC-affiliated programmers should apply. Therefore, regardless of the regulatory regime adopted by the Commission, an affiliation standard still is necessary. Furthermore, the current standard 5 percent standard should not be relaxed. A small ownership interest, or even certain non-ownership interests (*e.g.*, stock options or royalty arrangements) can provide an incentive for the LEC to *favor* a particular programmer, even if such interests do not necessarily give the LEC *control* over the programmer. Under a Title II regime, which is premised on nondiscriminatory access to the video platform, any interest which gives the LEC an incentive to favor a programmer should be cognizable for the purpose of determining compliance with channel caps, program access rules or other safeguards.

merely with a cable operator that owns an attributable interest in the programmer -- unless the Commission determines that such exclusivity is in the public interest. Section 628 also prohibits vertically integrated cable programmers from discriminating in the prices, terms, and conditions of the sale or delivery of their programming to MVPDs except under certain defined circumstances.

As a general matter, these restrictions on exclusivity and differential pricing can impair the ability of vertically integrated programmers to compete with other programmers. For example, a cable operator competing in an area with other distributors, such as DBS, MMDS and SMATV providers, may seek to attract subscribers by advertising the availability on its system of services not available on the competing services. Similarly, it will have little incentive to promote services that consumers can purchase elsewhere. Thus, the current inability to offer exclusivity to cable operators places vertically integrated cable programmers at a competitive disadvantage with those programmers unregulated by the 1992 Cable Act.

There is ample evidence regarding the current competitive strength and financial resources of telephone companies due to their local monopoly status in the delivery of telephone service. Thus, if telephone companies are permitted to provide their own packages of programming to subscribers and those packages include program services in which the telephone companies own at least a 5% interest, those program services should be subject to the same restrictions. It would unfairly distort competition both among programmers and among MVPDs to allow telco-owned programming services, but not cable-owned programming services, to offer exclusivity. Such a result would enable telco-owned programmers to gain the promotional benefits of exclusivity, while denying such benefits to cable-owned programmers.[7] Moreover, it would allow telco-owned programmers to refuse to deal with cable competitors of the telco's video facility, while cable-owned programming services are required to deal with cable's competitors.

Furthermore, while such an approach would give telco-affiliated program services an advantage over cable-owned program services, it would also give telco packagers an advantage by allowing them to develop attractive programming to be used to differentiate and promote their packages vis-a-vis competing cable systems -- which are prohibited from doing the same. All programmers, however, not merely vertically integrated programmers like Discovery, have an interest in full and effective competition among MVPDs. And all such programmers are adversely affected by regulations that unfairly skew and threaten to eliminate such competition.

---

[7] *See, e.g.*, Comments of Home Box Office at 4 ("To permit the affiliated programmers of telcos, functioning essentially as cable operators, to be exempt from the program access regulations would create an unjustified advantage for telco affiliated program services.")

B. The Record Supports Adoption Of VDT Regulations That Guarantee The Availability Of Channel Capacity For Access By Unaffiliated Programmers And Packagers To LEC Video Facilities

The FCC goals of greater video competition and programming diversity cannot be fulfilled by LEC entry if unaffiliated programmers and packagers cannot obtain transmission capacity on a LEC's video platform. Under Title VI, distributors are precluded from using more than 40 percent of system capacity for video programming in which the distributor has an interest.[8] This creates the opportunity for unaffiliated programmers to obtain carriage, subject to negotiations with the cable operator. If the Commission opts for Title VI regulation, this provision would leave some capacity available for unaffiliated programmers, although they would have no right of access.

Under a Title II regulatory framework, on the other hand, without available transmission capacity on the video platform, an unaffiliated programmer's or packager's mandatory right of access to the platform is an empty promise. Capacity shortages may well occur, especially in the near term before digital networks are fully deployed. Discovery therefore concurs with other commenters that a similar occupancy cap is warranted for LEC offerings regulated under Title II.[9] A cap would make more

---

[8] 47 U.S.C. § 533(f)(1)(B); *see* 47 C.F.R. § 76.504(a).

[9] *See* Comments of Motion Picture Association of America ("MPAA") at 11; Comments of Capital Cities/ABC at 19; Comments of NATOA at 33; Comments of Entertainment Made Convenient USA, Inc. ("EMC3") at 21.

meaningful the Title II right of access, thereby encouraging competitive entry by unaffiliated firms.

In the VDT Reconsideration Order, the Commission properly rejected LEC calls to allocate "all or substantially all" analog channels to any one predominant packager, or "anchor programmer," as inconsistent with a common carrier model and the requirement that LECs offer sufficient capacity to accommodate multiple video programmers.[10] Where a LEC is permitted to provide its own package of programming over its video platform, the risk is even greater that unaffiliated programmers' right of access -- and consumers' access to a diversity of information -- will be compromised. Indeed, a LEC providing affiliated programming on its video platform will face a strong incentive and, if unrestrained, the ready means to preclude the advent or viability of competing program packagers by artificially limiting their transmission capacity. Given this possibility, Discovery believes that the FCC-imposed obligation for LECs to provide sufficient "capacity and expandability" where "technically feasible and economically reasonable"[11] -- which the LECs claim obviates the need for caps[12] -- is simply too vague to effectively police LEC practices. Indeed, such a generic provision is likely to produce administrative litigation, rather than programmer access.

---

[10] *VDT Reconsideration Order*, CC Docket No. 87-266, FCC 94-269 (rel. Nov. 7, 1994) at ¶¶ 30-35.

[11] *See VDT Reconsideration Order* at ¶ 38.

[12] *See, e.g.*, Comments of Pacific Telesis Group, Pacific Bell and Nevada Bell at 19.

Instead, under a Title II regulatory scheme it is appropriate to adopt a presumptive cap on the percentage of a platform's analog[13] capacity that a LEC may devote to affiliated programming or program packages. While the Commission has determined that a LEC may not dedicate more than 50 percent of its capacity to any single unaffiliated program packager, Discovery believes that LECs' additional role as a packager on the video platform -- given the potential attendant competitive abuses described herein -- warrants a more stringent cap on LEC-affiliate use of total analog capacity. At a *minimum*, Discovery believes that a cap comparable to the 40% cap imposed in Title VI is warranted, although any specific numerical proposal must be evaluated under whatever comprehensive regulatory framework for VDT that the Commission ultimately adopts. By buttressing the general Title II access safeguard and related FCC pronouncements, a more stringent cap will provide unaffiliated programmers and packagers with concrete assurance that a LEC cannot preclude competition on its video platform.

C. The Record Supports Adoption Of Rules To Prevent LECs From Extracting Unfair Terms As A Condition To Carriage In Order To Assure Reasonable Access By Unaffiliated Programmers And Packagers To LEC Video Facilities

Terms of carriage are an important adjunct to the right of carriage. Access is of little value to a programmer if the LEC owning the video network is able to extract unfair

---

[13] While Discovery assumes, based on LEC representations, that digital capacity will be abundant and that caps on digital capacity therefore will not be necessary, Discovery nonetheless urges the Commission to monitor issue of digital capacity and impose an appropriate cap if warranted.

terms for a program service's inclusion in its affiliated package.[14] For example, Discovery, as an unaffiliated programmer, fears that a LEC might demand a financial interest in a programmer, or platform-exclusive carriage or subdistribution rights as a condition of carriage on its affiliated package. Alternatively, a LEC might discriminate against a programmer simply because it is not affiliated with the LEC.

If the Commission regulates LEC affiliated programmers as a cable system, the carriage agreement rules adopted under Title VI will provide protection for unaffiliated program services. The cable carriage agreement rules prohibit MVPDs from extracting, as a condition of carriage of a program service, a financial interest from the programmer or exclusivity rights with respect to other video distributors; the rules also prohibit MVPDs from restraining the ability of an unaffiliated programmer to compete fairly by discriminating against the programmer on the basis of its affiliation or non-affiliation.[15]

In the event that the Commission chooses Title II regulation, Discovery would agree with MPAA that cable carriage agreement rules like those provided in Title VI should be applied to LECs.[16] To prevent services not affiliated with telephone operators from being placed at an unfair and unwarranted genuine competitive disadvantage, parallel

---

[14] While Discovery would expect that a Title II regulatory regime, with the modifications suggested herein, would reduce the potential competitive disparity between the affiliate packager and unaffiliated packagers, there is a strong possibility that, at least in the early stages of VDT, inclusion in the LEC-affiliate package may be more desirable from a marketing perspective.

[15] 47 C.F.R. § 76.1302.

[16] MPAA at 10-11.

carriage agreement provisions must be added to the VDT rules.[17] Such rules would prevent a LEC from using its control over the likely dominant affiliate packager to force video programmers to, in effect, waive their right of access in exchange for inclusion in the affiliated package.

D. The Record Supports Adoption Of Rules To Guard Against LEC Discrimination In The Offering And Presentation Of Programming Options On Video Platforms

Not only do programmers and packagers wish to be carried, fair competition also requires that the LEC not discriminate against unaffiliated video providers in the manner in which the LEC offers and present affiliated and unaffiliated program services to its subscribers. Like other unaffiliated programmers, Discovery is concerned that a LEC might use its control over the video distribution system and menu (or similar level one directory) to unfairly favor the offerings of its affiliate.[18] Likewise, competition between affiliated and unaffiliated services and packagers will not develop unless, from a

---

[17] Alternatively, the Commission can affirmatively rule that program packagers, whether affiliated or unaffiliated with telephone companies, that provide programming to subscribers over a telephone company's facilities are deemed to be MVPDs.

[18] For example, it would constitute an abuse of a LEC's position as the administrator of a VDT system to list on a default directory screen its affiliate service or packager first or more prominently than the offerings of unaffiliated firms. *See, e.g.*, NBC at 23 (expressing concern that first screen of navigational device that subscribers view might omit broadcast stations). Discovery does not believe it is appropriate, however, to privilege any one class of programmer over another in the menu listing (*e.g.*, listing broadcasters first on the menu).

customer's perspective, a connection through a LEC's video system to an unaffiliated programmer is equivalent to an affiliate connection in terms of time, cost, and ease.[19]

Discovery agrees with the comments of programmers that, under a Title II regulatory regime, in the interests of fair competition the general duty to provide nondiscriminatory access requirement includes the presentation to end users of affiliated and unaffiliated program services and program packages.[20] This safeguard would be analogous to the "channel positioning" rules applicable to cable operators under Title VI regulation.

Accordingly, Discovery recommends that the Commission, if it applies Title II regulation, to require LECs to present and offer to customers, in a fair and unbiased fashion, all programming available on the level one platform and make the programming equally accessible to subscribers. Like the Title VI channel positioning rules, this provision would offer competing programmers and packagers more meaningful protection.

Protections against discriminatory menu and channel positioning and ease of access will be of little value, however, if telephone companies are able to provide favorable access to their own programming via unregulated Level 2 "gateways" and other services. The Commission has decided, at a time when telephone companies were flatly prohibited from providing their own programming on their VDT platforms, that telephone companies

---

[19] For example, a LEC might configure its VDT system such that users of an unaffiliated service must "descend" through multiple subdirectories to reach the desired service while the affiliate service can be reached at the first directory level.

[20] *See* MPAA at 12; NAB at 11; NBC at 3; *see also* NCTA at 32.

should be allowed to provide Level 2 services on an unregulated and discriminatory basis. But now the telephone companies have incentives to use such Level 2 services to favor their own programming and to deny such services to competing programmers. Therefore, at least until there is full and effective competition in the provision of gateways and other Level 2 services, the Commission should require that these services be made available to programmer-customers of the Level 1 platform on a fully nondiscriminatory basis.

E. The Record Supports Adoption Of Rules That Guarantee Open Access To Set-Top Boxes And Other Elements And Features Of The Video Network Necessary For A Programmer Or Packager To Serve Its Customers

Discovery joins a broad range of commenters in urging the Commission to ensure that its policy of open access to LEC video systems is not undermined by a LEC's control of the network design or set-top box capabilities.[21] In the absence of such rules, LECs might abuse their dual role of system operator and competitive program packager to impose artificial equipment and technical barriers to consumer access to unaffiliated programs and packagers. These concerns are heightened by the prospect that the LEC may offer a competing video package using a set-top box that is incompatible with unaffiliated programming. Indeed, video competition and service diversity is likely to develop only if unaffiliated programmers and packagers enjoy unimpeded access to, and

[21] *See* Compaq Computer Corporation at 2; EMC3 at 19; National Public Radio at 4; NATOA at 33.

timely technical information about, elements of the LEC's video network necessary to reach and serve customers.

While the matter of interoperability of set-top boxes is undergoing review in the Title VI context, the issue has not directly arisen in a Title II VDT context. The Commission should therefore clarify that -- in addition to existing safeguards such as the *Computer III* network disclosure rules -- the principle of nondiscriminatory access that it has championed with respect to the video platform extends to the set-top box, or the network equivalent, used by customers to receive VDT service under a Title II regulatory regime. The Commission's experience in regulating the interconnection of private equipment to the telephone network provides a useful precedent that should apply in the VDT context as well.

III. DISCOVERY CONCURS WITH COMMENTERS THAT THE COMMISSION SHOULD ADDRESS PARTICULAR COMPETITIVE CONCERNS ARISING FROM A LEC'S PROVISION OF ITS OWN PROGRAMMING

In addition to issues of access to the LEC video distribution system, Discovery also agrees with the comments of programmers, cable operators, broadcasters and government interests that a LEC's provision of both VDT transport and an affiliated program package creates a risk that the LEC might unfairly favor its affiliate over unaffiliated programmers and packagers.[22] Such behavior, if unchecked, would undermine the FCC goals of

[22] *See* MPAA at 5; California Cable Television Association ("CCTA") at 22; Cox Enterprises, Inc. ("Cox") at 16; NCTA at 43; The Association of Independent Television Stations, Inc. ("INTV") at 10; Capital Cities/ABC, at 12; NBC at 23; NATOA at 33.

fostering competition and programming diversity by choking the growth of new distribution outlets for unaffiliated video programming.

Accordingly, Discovery recommends that the Commission ensure that: (1) LECs do not injure competition through cross-subsidization of affiliated programming and facilities; (2) LECs do not use "channel sharing" mechanisms to impede competition; and (3) unaffiliated programmers and packagers are not placed at an unfair competitive advantage by a LEC's ability to jointly market telephone and video services and use customer proprietary network information ("CPNI").

A. To Prevent Anticompetitive Cross-Subsidization Of Video Programming And Facilities, The Commission Should Apply The Same Cost Allocation Rules As Apply To Unregulated Facilities And Services, Regardless Of Whether They Are Regulated Under Title VI Or Title II

The prospect of a VDT service with sufficient capacity to accommodate, on a non-discriminatory basis, a multiplicity of competing programmers and program packagers would enhance the opportunities for program networks to compete for carriage and subscribership and to receive full value from packagers and subscribers for their services. A number of comments, however, addressed the potential dangers of anticompetitive cross-subsidization of a LEC's video offerings from regulated basic services. Discovery concurs that the potential benefits of additional competition in video services from LEC entry would be frustrated if LECs are permitted to cross-subsidize improperly their video services with revenues from their local exchange monopolies.

First, the beneficial prospect of facilities-based competition between telephone companies and cable operators will be threatened if telephone companies can use cross-subsidization to gain an unfair competitive advantage. Second, if the provision of video facilities gives telephone companies the opportunity to subsidize their own *programming services*, the adverse effects on competing programmers will outweigh any pro-competitive effects of VDT service.[23]

The Commission's cost allocation rules require LECs to distribute fully their costs between regulated and unregulated services. There is little dispute in the opening comments that these rules would apply to video *programming* produced by the LECs. Accordingly, the Commission should affirm that LECs must fully and separately account -- as an unregulated service -- for their costs incurring in developing and producing program services.

Similarly, the LEC *packager* (in the Title II environment) or *cable operator* (in the Title VI framework) that selects program services to present to end users in a package would not be engaged in a common carrier service, but in an unregulated editorial activity. As such, it too would be on the unregulated side of the cost accounting ledger, subject to fully distributed cost allocation, whether it is deemed to be a cable operator or a VDT

---

[23] MCI provides a detailed explanation as to why the ability of the telephone companies to provide their own video programming increases the incentives and opportunities for anticompetitive mischief. Comments of MCI at 7-8.

packager. This would help to protect both cable operators and competing VDT program/packagers from harmful cross-subsidization.

More difficult cost allocation and accounting questions arise in the context of LEC video *facilities*. The opening comments evidence considerable disagreement regarding how the LECs should be required to account for their network facilities costs, particularly where a LEC will also be providing video programming to end users over those facilities. Cable operators express concern that LECs could injure competition from existing cable systems by cross-subsidizing their video facilities from regulated telephone services, while voice telephony customers express fears over higher rates that would serve as the source for such cross-subsidies.

To the extent that the Commission elects to regulate vertically-integrated LEC programmer/packagers and network providers under Title VI, then the LECs' video facilities would not be considered regulated common carrier facilities, but rather would be cable systems. In that event, the video facilities would not fall within regulated accounts, but would be deemed an unregulated service under the Commission's cost accounting rules.[24] This approach would go far towards alleviating the concerns expressed by cable operators that telephone companies would have excessive ability to cross-subsidize their video facilities.

To the extent that a telephone company's video facilities and services are treated as regulated common carrier facilities and services under Title II, the Commission's

---

[24] *See* 47 C.F.R. § 64.901.

existing regulatory structure is not well-suited to detecting improper cross-subsidization. That structure, as primarily embodied by Parts 32, 36, 64 and 69 of the rules, was not designed to deal with the construction of telephone company facilities to provide services that, while regulated under Title II, compete with similar services provided by cable operators. Ordinarily, when the telephone company provides competitive services, it does so on an unregulated basis (*e.g.*, enhanced services or customer premises equipment) and the Commission's accounting rules ensure that the costs associated with such services are separated from the costs of its regulated services so that they are not recovered from regulated ratepayers.[25]

But to the extent that VDT service is a regulated Title II service, its costs are not similarly segregated from other regulated telephone service costs under Part 64. To the contrary, while telephone companies are required to move the *fully allocated costs* of facilities used to provide unregulated services off their regulated books, under the price cap "new services" test they are required to recover from their VDT customers only the *direct* costs associated with the provision of video services plus some undetermined portion of overhead -- which, the Commission has indicated, may be something *less* than fully allocated costs. While this treatment may be appropriate for new regulated telephone services that use a LEC's existing facilities and personnel, VDT requires a massive new

[25] Only recently have LECs begun to face any competition in their provision of regulated interstate telephone services. The Commission's price cap rules generally are adequate to minimize cross-subsidization of these services because they do not require construction of new facilities, nor do they generate substantial new overhead costs.

investment in facilities plus a substantial increase in overhead attributable to new engineering, marketing, accounting and customer service needs. By not requiring LECs to recover *all* these costs from video customers (or shareholders), the Commission's existing accounting rules facilitate cross-subsidization of the LEC's regulated facilities and services with revenues from their regulated telephone services. Wholly apart from the effects on telephone ratepayers, this cross-subsidization will have a significant impact on LEC competitors in the video programming and video distribution markets who do not have the ability to shift costs to captive customers.

Thus, if the Commission continues to regulate the telephone companies' video facilities under Title II, then the cost allocation rules will need to be amended to address the anticompetitive risks associated with the provision of such regulated facilities. In particular, the Commission should apply the same cost allocation principles to VDT service as it applies to unregulated telco services. For the reasons and in the manner set forth by MCI: (1) "Part 32 must be revised to allow the Commission and interested parties to ensure that VDT costs are not borne by telephone ratepayers"; (2) "Part 36 rules should be modified to account for the jurisdictional effects of the new VDT networks"; (3) "Part 64 rules should be modified to take into account the separate account categories stemming from a revision of Part 32 categories"; and (4) "Part 69 should be modified to allow for separate access charges for VDT and a distinct VDT basket must be put in place."[26]

---

[26] MCI at 12-13.